HEDGE FUNDS: FERTILE FOR MISUSE AND ABUSE

More “average” Americans are investing in today’s securities market without much investment experience or knowledge. As returns on traditional investments plummet, investors look for alternative avenues of obtaining above-average returns. Inexperience and desire for higher returns can lead investors to unsuitable or even fraudulent investments. Hedge funds provide a fertile field in which promoters may take advantage of investors. Seen as funds with “secret” investment strategies reserved for the wealthy, hedge funds may attract investors who want to receive the same perceived investment advantages.

The name “hedge fund” originated because of the investment strategies used by the managers of such funds. The investment goal was to achieve above-average returns independent of the trends of the underlying market by using “hedging” strategies. Investment managers use hedging techniques to maximize gain. These techniques include selling short, buying put or call options, leveraging, simultaneously buying and selling the same security in different markets, investing in distressed or bankrupt companies, and investing in volatile international markets.

Modern hedge funds are so called primarily because they are structured so that they are exempt from most securities regulation. The types of investments made by the funds vary widely. In order to be exempt from regulation such as registration and disclosure requirements, limits on fees and derivatives investing, and liquidity requirements, hedge funds are sold privately to wealthy investors. Wealthy investors typically are experienced and knowledgeable about a variety of investments and investment strategies and are viewed as less likely to need additional regulatory protection.

Because they are not subject to regulatory oversight, hedge fund managers “protect their investment strategies” by not disclosing much information about their operations. An investor may have difficulty ascertaining investment strategy, level of risk, how fund assets are valued and by whom, and the manager’s track record. In addition to “protecting” investment strategies, remember that nondisclosure can also shield fraud. The number of actions brought by the Securities and Exchange Commission against hedge funds has increased dramatically in recent years. Commonly in these cases the hedge fund promoters lied about the experience of the managers and the funds’ track records. Many cases involved classic Ponzi schemes in which the early investors were paid from the money invested by subsequent investors rather than from the fund’s performance.

If you can afford to lose all of your investment dollars, you can afford to take higher risks, with the possibility—not the guaranty—of higher returns. But whether you can afford to lose your investment dollars or whether those dollars represent your future, you need to understand the investment and know the promoter before you hand over your money.

You need to thoroughly understand two things about hedge funds: (1) Even legitimate hedge funds involve a high degree of risk; and (2) increasingly hedge funds are being used by inexperienced or unscrupulous promoters as vehicles to obtain your money.

A current trend is to sell to “average” investors a fund that invests in hedge funds—the fund of funds may be registered with the Securities and Exchange Commission and may be sold publicly. When reviewing promotional materials regarding a fund of hedge funds, remember that the materials should provide you with a balanced view of the investment: the benefits *and* the risks.

Before investing in a fund of hedge funds, make sure you investigate and understand the following:

- Who is managing the fund that will be investing in the hedge funds? What criteria will the fund manager use when choosing hedge funds in which to invest? What qualifies the manager to manage this fund? How experienced is the fund manager? Does the fund manager have any disciplinary history? Is the fund manager licensed or registered with a regulatory agency?

- Who is managing the hedge funds in which the fund will invest? What investment strategies are the hedge fund managers using? What qualifies the managers to manage hedge funds? How experienced are the hedge fund managers? Do any of them have any disciplinary history? Are any of the managers licensed or registered with a regulatory agency?

- What are the fees being charged by the fund that will be investing in the hedge fund? What expenses will be taken from the fund for its operation? How do those fees and expenses compare to other types of funds?

- What are the fees being charged by the hedge funds? (Hedge funds typically charge an asset management fee of one to two percent of assets, plus a performance fee of twenty percent of the fund’s profits.) What expenses will be taken from the hedge funds for their operation? How does the double layer of fund fees and expenses and hedge fund fees and expenses impact your investment return?

- What are the risks associated with the various investment strategies that may be used by the fund or the hedge funds in which the fund invests?

- How are the values of the investments held by the hedge funds determined? Are the values based on liquid, active markets? Are the values placed on illiquid assets by independent third parties? Do the fund managers place their own valuations on their funds?

- How often will you receive reports about the fund’s operations and what type of information will the reports contain? How can you verify the contents of the reports?

- When, how, and to whom can you sell your shares of the fund? Is your right to redeem your shares limited in any way?

- What does the salesperson get if you make this investment?

- Based on your personal goals, investment time frame, risk tolerance, and available investment dollars, is this type of fund suitable for you?

For more information regarding hedge funds and funds of hedge funds, visit the Securities and Exchange Commission web site at http://www.sec.gov/answers/hedge.htm. Additionally, the National Association of Securities Dealers has issued a reminder to its members of their obligations when selling hedge funds. This reminder contains information with which you should be familiar before making an investment decision: http://www.nasdr.com/pdf-text/0307ntm.pdf.

The Arizona Corporation Commission's Securities Division is committed to making Arizona a safe place for investors. While the Division cannot offer you legal or investment advice, I encourage you to contact the Division with any question you may have about the risks inherent to an investment, or the registration or disciplinary history of a promoter, a securities dealer or salesperson, or an investment adviser. The Division may be contacted at 602-542-4242, toll free at 1-866-VERIFY-9, or by e-mail at **info@azinvestor.gov**.

By W. Mark Sendrow
Former Director of the Securities Division

Article Date: 03-25-2003